Indiana Department of State Revenue

Revenue Ruling #2005-14ST

December 9, 2005

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ISSUES

Use Tax—Leasing of an Aircraft to an Affiliated Entity

Authority: IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-3-4; IC 6-2.5-5-8(b); IC 6-2.5-3-5; IC 6-6-6.5-2; IC 6-2.5-4-10(a); IC 6-2.5-2-1; Indiana Dept. of State Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); FAR § 91.1; FAR § 91.315; FAR § 91.325; FAR § 91.501; FAR § 1.1.

STATEMENT OF FACTS

The taxpayer is an limited liability company that was formed for the business purpose of owning and leasing aircraft. The taxpayer owns an aircraft and leases it to an affiliated entity. The taxpayer states that the aircraft is leased under a five year dry lease which is absolute and unconditional to the affiliated entity. The taxpayer also states that it has valued the aircraft and has determined a rate of return on the aircraft investment. Taxpayer states that based on the analysis, it was determined the projected internal rate of return exceeds the taxpayer's cost of capital and will provide the taxpayer a profitable return on the investment. The aircraft has been hangared in another state from the lease inception until now. The taxpayer has collected and remitted sales tax on the monthly lease payments as required by that state's law.

The taxpayer describes the business purposes of the affiliated entity; the affiliated entity is in a business unrelated to aircraft. The business objectives of the affiliated entity are to maximize shareholder value through its management and development of [building enterprises]. The taxpayer states that it makes business sense for the affiliated entity to lease aircraft to ease the travel burden for senior level executives that manage 90 [building enterprises] throughout the United States; it does not make sense for the affiliated company to own aircraft or distort its financial statements with financial results related to the ownership of aircraft. The taxpayer was formed for the purpose of owning and leasing aircraft.

The taxpayer requests a ruling on the tax consequences of basing and hangaring the aircraft in Indiana.

DISCUSSION

IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft—unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of sales and use tax exist. *See* IC 6-2.5-5 and IC 6-2.5-3-4. IC 6-2.5-5-8(b) exempts from sales tax, property acquired for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.

Indiana Dept. of State Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-2.5-3-5, Credit for payment of other taxes, states:

> A person is entitled to a credit against the use tax imposed on the use, storage, or consumption of a particular item of tangible personal property equal to the amount, if any, of sales tax, purchase tax, or use tax paid to another state, territory, or possession of the United States for the acquisition of that property.

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date or for a non-resident who bases an aircraft in this state for more than 60 days to register the aircraft with the Department within 60 days after establishing a base in Indiana.

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by the taxpayer to the affiliated company. The taxpayer and affiliated company do not dispute this.

However, the taxpayer claims it is entitled to a use tax exemption on the acquisition of the aircraft because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements the taxpayer has entered into with the affiliated entity. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this ruling—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See*

FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. The taxpayer does not state in its ruling request under which Part the aircraft is operated, but based on the information provided, which is that an exclusive five year dry lease has been executed with the affiliated entity, it is reasonable to presume that the aircraft is operated under Part 91 and not Part 121 or 135.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service. The taxpayer has indicated that it does not operate a transportation service, but instead is in the business of owning an aircraft for dry leasing.

Analysis of the form and function of the lease agreement and arrangement

The affiliated entity has a need for an aircraft to transport its employees. Because the taxpayer and the affiliated company are related, some of the employees and officers are the same persons. For example, the Chief Financial Officer who signed the lease agreement for the taxpayer is also the Chief Financial Officer who signed the lease for the affiliated entity.

If the affiliated entity had purchased an aircraft, sales or use tax would have been due because no applicable tax exemption could be leveraged. But if the aircraft is purchased by an affiliated company and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales or use tax in a lump sum by claiming to "rent" the aircraft to themselves and then paying sales tax over time when it is collected on the lease payments. The taxpayer's aircraft was purchased at over $9 million. The avoidance of the lump sum sales and use tax on that amount is understandable. But in order to comply with FAA Part 91 requirements, the taxpayer cannot operate the aircraft on behalf of the affiliated entity. Under FAA regulations, control of the aircraft has to be placed with the affiliated entity. The taxpayer claims that the placement of the aircraft into a separate entity serves to not distort the

financial statements of the affiliated company with the ownership of an aircraft. But the taxpayer doesn't operate the aircraft—it merely holds the asset for the benefit of the affiliated company. When the transaction is collapsed, the affiliated entity still has control and use of a capital asset. The Department acknowledges that placement of the aircraft into a separate but related company makes sound business sense so as to not distort the financial records. But under the FAA regulations, in order for the aircraft to be operated under Part 91, all control and costs of operating the aircraft must be placed into the hands of the lessee, in this case, the affiliated entity. These operational costs are part of the affiliated company's running of its business. The exclusive control of the aircraft is also a cost of the affiliated company doing business.

The net effect of all this is that the affiliated company gets control and use of an aircraft; but it has avoided the upfront, one-time cost of having to pay the sales or use tax due. If the affiliated company had purchased the aircraft outright, it still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as it has, the affiliated company still gets the benefit of an aircraft and the lease payments made to the taxpayer are a wash in the overall combined financial picture of the taxpayer and the affiliated company because the two companies are related—thus the lease payments are inter-company transfers.

The taxpayer acknowledges that it is related to the affiliated entity. There is not rental and leasing to others; it is renting and leasing to self. IC 6-2.5-5-8(b) grants a sales and use tax exemption if the person acquiring the property acquires it for resale, rental, or leasing [to others] in the ordinary course of the person's business. The taxpayer is not engaged in rental or leasing to others for the purposes of the use tax statutes.

RULING

The Department rules that the taxpayer will be liable for use tax if it bases the aircraft in Indiana.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer’s facts and circumstances, as stated herein are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford taxpayer any protection. It should be noted that subsequent to the publication of this ruling, a change in statute, regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection

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